

# CRS Report for Congress

Received through the CRS Web

## FHA Loan Insurance Program: An Overview

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### Summary

The Federal Housing Administration (FHA) was created by the Housing Act of 1934 in order to broaden homeownership, protect lending institutions, and stimulate the building industry. By insuring lenders against loss on home loans, FHA contributed to the institution of the 30-year mortgage as a standard mortgage product. When the Department of Housing and Urban Development (HUD) was created in 1965, FHA became an agency of HUD. From its inception in 1934 through the end of FY2002, FHA has insured about 30.9 million loans. This report discusses the features of the FHA program to insure loans on single family homes. The report will be updated as suggested by changes in law or regulation.

### A Brief History of the FHA Home Loan Insurance Program

FHA was created by the National Housing Act of 1934 during the height of the Great Depression. The Act had three objectives: (1) to broaden homeownership, (2) to shore up and protect home financing institutions, and (3) to stimulate employment in the building industry.

Through the newly created Mutual Mortgage Insurance Fund, the FHA was authorized to insure lenders against loss on home loans. The loans could have up to 20-year terms and were limited to 80% of the appraised value of the property, with a maximum mortgage of \$16,000. Initially, FHA provided insurance to individual purchasers of single-family homes and to corporations who purchased or built low-rent multiple-family housing.

FHA-insured loans fostered the change from short-term balloon mortgages to long-term fully-amortizing mortgages. Prior to the creation of FHA, few mortgages exceeded 50% of the property's value and most mortgages were written for terms of 5 years or less. At the end of the 5-year term, the remaining loan balance had to be repaid or the mortgage had to be renegotiated. Borrowers generally had little trouble in obtaining new mortgages.

During the Great Depression, however, lenders were unable or unwilling to refinance many of the loans that became due. Thus, many borrowers lost their homes through foreclosure, and lenders lost money because property values were falling. Lenders became wary of the mortgage market.

FHA institutionalized a revolutionary idea – 20-year mortgages on which the loan would be completely repaid at the loan term. If borrowers defaulted, FHA insured that the lender would be fully repaid. Mortgage instruments were standardized and a new confidence was instilled in the mortgage market. Investment in housing was stimulated and its ripple effects were felt throughout the economy. Eventually, lenders began to make long-term mortgages without FHA insurance if borrowers made significant downpayments. Over time, 25- and 30-year mortgages have become standard mortgage products.

When the Department of Housing and Urban Development (HUD) was created in 1965, FHA became an agency of HUD. This report discusses the features of the FHA program to insure loans on single family homes. Single family homes are defined as properties containing from one to four dwelling units.

## Features of the Program

**Eligibility.** FHA-insured loans are available to owner/occupants who can demonstrate the ability to repay the loans according to the terms of the contract. Parties who are in default on previous FHA-insured loans may not be eligible for new loans unless the default is cleared or the borrower can show that the default was caused by circumstances beyond the borrower's control. Likewise, parties, who have previously defaulted on non-FHA insured loans, may not be eligible for FHA-insured loans.

**Maximum Mortgage.** The mortgage limits for FHA-insured loans are set on an area-by-area basis and the limits are indexed to the lesser of two benchmarks: (1) the median home price for the area, or (2) the size of loans that may be purchased by the Federal Home Loan Mortgage Corporation (Freddie Mac).<sup>1</sup> For a one-family property, the FHA mortgage limit for an area is the lesser of (1) 95% of the median home price for the area or (2) 87% of the Freddie Mac limit for one-family properties, but the FHA limit may not be less than 48% of the Freddie Mac limit.

Since the Freddie Mac loan limits may change on January 1<sup>st</sup> of each year, the FHA mortgage limits may also change annually. As of January 1, 2003, the maximum FHA-insured mortgages (87% of the Freddie Mac limits) are \$280,749 for one-family properties, \$359,397 for two-family properties, \$434,391 for three-family properties, and

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<sup>1</sup> Freddie Mac is a stockholder-owned corporation chartered by Congress in 1970 to create a continuous flow of funds to mortgage lenders in support of homeownership and rental housing. Freddie Mac purchases mortgages from lenders and packages them into securities that are sold to investors. After borrowers complete the closing process on their mortgage loans, Freddie Mac buys those mortgages from approved lenders. The process of replenishing the supply of funds enables the lenders to make mortgage loans to other borrowers. The size of loan Freddie Mac may purchase is set by statute and the limit may be adjusted on January 1<sup>st</sup> of each year, based on changes in the national average home prices.

\$539,835 for four-family properties. The National Housing Act provides that mortgage limits for loans in Alaska, Guam, Hawaii, and the Virgin Islands may be adjusted up to 150% higher. The minimum FHA mortgage limits (48% of the Freddie Mac limits) for an area are \$154,896 for one-family properties, \$198,288 for two-family properties, \$239,664 for three-family properties, and \$297,840 for four-family properties.

The Freddie Mac limits determine the upper and lower FHA limits while the median home price may determine the actual FHA limit for an area. For example, the one-family limit for FHA-insured loans in New York, NY is \$280,749. This implies that 95% of the median home price is greater than \$280,749, so \$280,749 becomes the FHA limit because the FHA limit may not exceed 87% of the Freddie Mac limit (except in Alaska, Hawaii, Guam, and the Virgin Islands.) The one-family limit for FHA loans in Boone County, NE is \$154,896. This implies that 95% of the median home price is less than \$154,896, but the law provides that the FHA limit for an area may not be less than 48% of the Freddie Mac limit. The one-family limit for FHA-insured loans in Santa Fe, NM is \$242,250, which is 95% of the median home price for the area.

**Loan Term.** FHA-insured loans may be obtained for mortgages with terms of up to 30 years. In special cases, low-income borrowers may be eligible for 35-year loans to make the mortgage more affordable.

**Downpayment.** In general, the downpayment will be either of the following:

- 1.25% of the value of the property for a property appraised at \$50,000 or less;
- 2.35% of the value of the property for a property valued in excess of \$50,000 but less than \$125,000;
- 2.85% of the value of the property for a property valued at \$125,000 or more;
- 2.25% of the value of the property for a property valued in excess of \$50,000 that is located in an area of the state for which the average closing costs exceed 2.1% of the average closing costs for the state.

If a borrower is an investor assuming an FHA-insured loan which was closed between February 5, 1988 and December 15, 1989, the downpayment must ensure that the loan-to-value ratio is no more than 75%.

**Owner Occupancy.** Generally, for loans closed on or after December 15, 1989, the borrowers must intend to occupy the property as a principal residence. Property that has been acquired by FHA as a result of default or foreclosure by the borrower may be sold to owner-occupants or investors, and in some cases the borrowers may obtain FHA-insured loans.

**Eligible Loan Purposes.** FHA-insured loans may be used to purchase single-family detached homes, townhomes, rowhouses, two-to-four family buildings, manufactured homes and lots, and condominiums in developments approved by FHA.

The loans may also be used to build a home; to repair, alter, or improve a home; to refinance an existing home loan; to simultaneously purchase and improve a home; or to install a solar heating and cooling system or other weatherization improvements.

**Program Funding.** The FHA home mortgage insurance program is funded by the FHA Mutual Mortgage Insurance Fund (MMIF). The MMIF is authorized to fund all operations of the mortgage insurance program, including administrative costs.

The MMIF has been able to fund all operations of the FHA home mortgage insurance program (including salaries) without appropriations from Congress. The MMIF was designed to be actuarially sound and self-supporting. A few years after its creation, the MMIF began to earn a positive net income, and it had consistently been profitable since then. In FY1987, however, the fund barely broke even, and, in FY1988, the MMI fund suffered its first net loss. In prior years, losses were offset by income from insurance premiums, interest earnings, and proceeds from the sale of homes that had been acquired through foreclosure on FHA-insured loans. In 1988 and 1989, however, the income to the fund was insufficient to cover the losses. A reserve of several billion dollars had been built up due to the fund's past profitability, but, if losses had continued, the reserve would have been depleted, and the MMI fund would have been insolvent and in need of general funds from the U.S. Treasury. The fund had about \$4 billion in reserves at the end of FY1987, but, at the end of FY1991, the fund had about \$871 million in reserves.

Thus, FHA was forced to examine its practices, and legislation was enacted (P.L. 101-235, P.L. 101-508 and P.L. 101-625) to change the program operations. The payment of mortgage insurance premiums was changed to reflect the risk of the loans being insured. (See the section on mortgage insurance fees.)

According to HUD, the MMI fund has experienced a financial turnaround. The fund has an estimated positive economic value of \$18 billion at the end of calendar year 2001, compared to a negative economic value of \$2.6 billion in 1990. (To date, the analysis of the 2002 data has not been completed and released.)

**Mortgage Insurance Fees.** For any loan insured on or after January 1, 2001, the borrower will pay an up-front mortgage insurance premium of 1.5% of the loan amount. In addition, the borrower will pay an annual insurance premium and the amount and duration of the premium will be determined by the size of the downpayment: (1) a borrower who makes a downpayment in excess of 10% will pay an annual insurance premium of 0.5% of the loan balance for the first 11 years of the loan, (2) a borrower who makes a downpayment of 5% to 10% will pay an annual premium of 0.5% for the first 30 years of the loan, and (3) a borrower who makes a downpayment of less than 5% will pay an annual premium of 0.55% of the loan balance for 30 years.

If borrowers prepay their loans, they may be due refunds of the prepaid insurance which was not "earned" by FHA. The refund amount depends on when the mortgage closed and the amount declines as the loans mature. For loans closed on or after January 1, 2001, if a 30-year mortgage were paid off at the end of the first year, the borrower would be refunded about 75% of the insurance paid. At the end of 3 years, 35% of the insurance would be refunded. None of the insurance would be refunded if the loan is paid off after the end of 5 years. The entire fee is considered as "earned" by FHA after the loan has been outstanding for 5 years.

For loans closed after July 1, 1991 but before January 1, 2001, the 7-year refund schedule remains in effect. For example, if a 30-year mortgage were paid off at the end of the first year, the borrower would be refunded about 90% of the prepaid insurance.

At the end of 4 years, less than 40% of the insurance would be refunded. None of the insurance would be refunded if the loan were paid off after the end of 7 years. The entire fee is considered as “earned” by FHA after the loan has been outstanding for 7 years. The annual insurance premiums are not refundable.

For loans closed on or after January 1, 2001, the annual mortgage insurance premium will be automatically cancelled when, based on the initial amortization schedule, the loan balance reaches 78% of the initial property value. Borrowers may also request cancellation of the mortgage insurance when the 78% loan-to-value ratio is reached due to advance payments by the borrower.

**Interest Rates.** The interest rate on FHA-insured loans is negotiated by the borrower, seller and lender. The borrower has the option of selecting a loan with an interest rate that is fixed for the life of the loan or one on which the rate may be adjusted annually.

**Underwriting Guidelines.** FHA-insured loans must be underwritten in accordance with accepted practices of prudent lending institutions and FHA requirements. The FHA credit analysis worksheet is used to examine the applicant’s personal and financial status, monthly shelter expenses, funds required for closing expenses, effective monthly income, and debts and obligations.

As a general rule, the applicant’s prospective housing expenses should not exceed 29% of gross effective monthly income. If the ratio exceeds 29%, compensating factors, such as savings history and past credit management, should be presented.

The applicant’s total obligations, including the proposed housing expenses, should not exceed 41% of gross effective monthly income. Again, compensating factors should be evident if this condition is not met.

Since August 1986, names of applicants for FHA-insured loans are to be checked against the most recent list of “problem mortgagors.” These are those borrowers who (1) have been reported as delinquent for 90 days or more on an existing FHA-insured mortgage, or (2) were borrowers under an FHA-insured mortgage on which FHA has paid an insurance claim during the preceding 3 years. These applicants are to be automatically denied credit unless the delinquencies have been cured or extenuating circumstances are shown. Credit is automatically denied to applicants whose credit report indicates a delinquency of 90 days or more on a non-FHA-insured loan, or foreclosure on such a loan in the past 3 years.

**Credit Limits.** The volume of FHA insurance commitments is subject to a fiscal year ceiling set by Congress. During FY2003, FHA may make insurance commitments which total no more than \$165 billion.

**Program Activity.** During FY2002, FHA wrote \$150.4 billion in insurance to insure the purchase or refinancing of more than 1.4 million housing units. At the end of FY2002 FHA had \$506.6 billion of insurance in force on about 6.3 million homes. From 1934 through the end of FY2002, FHA has insured about 30.9 million home loans at a mortgage volume of about \$1.6 trillion.